By Richard C. Rahnema of Watchel, Biehn & Malm

9 QUESTIONS You Must Ask Before Buying a BUSINESS

Everyone knows a friend, or a friend of a friend, that has purchased or sold a business, which did not end well. A common denominator of those "bad deals" is the lack of a written document outlining the terms of the agreement. The number of these situations will increase dramatically over the next decade because baby boomers are preparing for retirement and are driving an increase in small business sales. I am contacted on a regular basis to help buyers and/or sellers through the sale of their business. This article will outline most of the potential problems a buyer may run into when purchasing a business. Almost always, a consultation with an attorney before a business is purchased will reduce or eliminate any problems. I commonly tell people that spending money up front in the sale of a business is essential, because if you do not work out the potential problems before they start, it will take 10 times lengthy and expensive to unwind the problem. It is simple: the key is preparation. As Benjamin Franklin said, "Diligence is the mother of good luck."

What are you buying?

This should be determined during the first discussion between the buyer and seller. It is imperative that both parties know exactly what is being purchased. The following are some questions which need to be answered: is your business an incorporated entity, such as a Limited Liability Company (LLC)? Is the buyer purchasing the shares of the business? Is the buyer purchasing all the assets of the business, or only specific assets? Is the sale of real property involved? What about: customer list, suppliers list, phone number, logos, business name, furniture, fixtures, tools, parts, inventory, equipment, and intellectual property or trade secrets part of the sale? Will the seller promise not to compete against the buyer after the sale? What is the value for all of the items in the sale agreement?

How do I know I am getting a good deal?

Due diligence is used to describe a process wherein the buyer completes an investigation/audit into a potential investment. If you are going to spend your hard earned money, you need to make sure you have thoroughly investigated everything about the purchase of the business. Examples include: tax returns, profit and loss statements, cash flow statements, balance sheets, existing contracts, personally inspect physical assets, survey the property, order an appraisal, review previous appraisals, talk to employees, etc. This investigation might show: equipment which needs to be serviced or has liens, expired inventory, high accounts payable, use of a trade name which cannot be transferred, pending lawsuit, employee issues, equipment or building lease expiring shortly, a piece of the property is owned by another person, and warranty work the prior owner is responsible for. You can only blame one person if you do not perform adequate due diligence: yourself.

How will the payment be structured?

If you can pay cash for the purchase, you are in a great position; however, most buyers will require financing. Financing can come in a few different forms, but the most common is a promise to pay the seller the total amount over a period of time. For example, buyer will pay half of the purchase price in cash and will promise to pay monthly installments over the next 12 months. This is typically done with a Promissory Note and the seller will most likely request security if the buyer defaults on the payments: Deed of Trust commonly known as a Mortgage (real property); Uniform Commercial Code Filing (equipment); or some other person as a guarantor (another person becoming personally liable). Both parties must understand what happens if the buyer defaults (cannot make a payment) before signing the agreement. A few questions to consider: How many days does the buyer have to remedy the default? Can the seller take the business over? Can the seller seize the equipment and sell it? Can the seller foreclose on the real property? What happens if the buyer dies? Does the seller need to take an insurance policy on the buyer? Some sellers will not want to structure a sale with financing because of the risk, and will require the buyer to obtain money from another source, such as a bank.

Should I obtain an appraisal?

Yes, if you can afford it. You may think you know what the business and real property is worth, but you are really just guessing. That being said, an appraisal is an educated guess of the value of the business or real property utilizing different formulas, which are performed by a qualified person. If there is real property involved in the transaction, an appraisal and surveyor should be your first step. The second step is speaking with a realtor, contractor, and inspector to determine the pros and cons of the real property.

Do I need an attorney?

Maybe. It really depends on the type of deal you are making; however, the best course of action is to utilize an attorney to determine which professionals purchase of the business will require. Typically, you can obtain this type of general legal advice in an initial consultation, which could be $100-$300. Most attorneys will counsel you to reduce the agreement to writing, which is the way all business deals should be structured.

Do I need an escrow agent?

The purpose of an escrow agent is to put a neutral third party in the middle of the buyer and seller to facilitate the sale in order to ensure everything goes smoothly. The escrow agent will make sure all documents are signed, notarized and recorded (deeds and lease assignments), and disburse sales proceeds by paying: (1) the escrow agent, (2) creditors, (3) taxes and insurance, and (4) the balance to the seller. Without any doubt, if real property is involved, you should contact a local escrow agent. For example: a buyer is purchasing a business and the building. As the buyer, you will want to make sure the seller has the legal right to sell to you, you are receiving the building without liens, and the money is being held before the seller signs any deed transferring the real property.

Do I need an accountant?

Maybe. Once again, it depends on the type of business being purchased. There are costs associated with making sure you understand what you are getting. As part of your due diligence, the buyer needs to have a good understanding of how the business has structured its earnings and losses; and, how they have documented the business from a tax perspective. If you do not have any experience in reviewing the financials of a business (Balance Sheet, Cash Flow Statement, Operating Statements, etc.); do not start now. Having an accountant spend time reviewing the past 1-5 years of the business financials may save you hundreds, thousands, or hundreds of thousands of dollars before or after the sale. Additionally, there are tax advantages to allocating the purchase price of: inventory, tenant improvements, goodwill, non-compete, etc.

Do we need a written agreement?

Yes. The days of doing a deal on a handshake are gone. You need to protect yourself even if you do not think anything will happen to your deal. Even if you do not hire a professional to draft the agreement, the main terms of the contract should be written out. It is a huge mistake not to get the main terms in writing (email, text, napkin). Most people facing large legal bills when a sale falls off the tracks are those who not have a written agreement.

What is a covenant not to compete?

A covenant not to compete, or a non-compete clause, is an agreement in which the seller agrees not to work for the buyer's direct competition in a specified area and for a certain amount of time. For example, you thought the seller was not going to compete against your business once the sale is complete, but the seller started a business with a different name and is targeting your clients. You just invested all the money you had into a business and now you are faced with hiring a lawyer (with cash you do not have) in order to preserve the business before your business fails. Someone purchasing a business may not think to discuss this issue and the seller may assume they can compete against the buyer. Remember, the sale of the business probably included goodwill, which was created by the seller operating the business. In order to prevent this from happening, the seller (individually) needs to sign a written document containing the terms of this non-compete agreement. The law requires the agreement to be limited to a reasonable scope of work, amount of time, and distance.

Miscellaneous Questions

Are there contracts to be assigned to the buyer? Who gets the accounts receivable? Who gets the accounts payable? Is there any other inventory or equipment in the sale? Does seller have ownership of all assets free of any other interests? Are there any alarm codes? Any safes requiring codes or keys? Is there intellectual property being transferred? How do you limit liability of the parties? What representations have both parties made? What is the date to close the sale? Is the purchase contingent on the buyer obtaining a lease from the owner of the property? Is the seller going to promise to hold the buyer harmless regarding any potential liabilities which occurred before the sale of the business? Can the liquor license be transferred? Are there outstanding gift certificates or promotional sales you will be responsible for? Should an arbitration clause be included? If a lawsuit is filed regarding the agreement, which state should the lawsuit be filed in? Is the business in good standing with state of Arizona? Is the business in compliance with all local, state and federal laws, rules and regulations? Has an environmental assessment been conducted? Is there litigation pending?

The purchase of every business is different and each transaction needs to be carefully reviewed. Speaking with an: attorney, accountant, appraiser, surveyor, inspector, escrow agent, business broker, contractor, and realtor will ensure you have completed your due diligence properly. Remember: preparation and diligence have everything do with the success of buying a business.

"Give me six hours to chop down a tree, and I will spend the first four sharpening the axe."
–Abraham Lincoln